Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Nakano, et. al. | Analyst: John Pavalasky | Bill Number: AB 1783

Related Bills: See Legislative History | Telephone: 845-4335 | Amended Date: 04-12-2000

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Exclusion/Gain from sale of qualified small business stock held more than 5 years/increase to 100% for stock issued after effective date in 2000

X DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced 01-25-00.

___ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

___ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

___ FURTHER AMENDMENTS NECESSARY.

X DEPARTMENT POSITION CHANGED TO SUPPORT.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED 01-25-00 STILL APPLIES.

___ OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law, this bill would increase to 100% the exclusion of gain on the sale of qualified small business stock, as defined, originally issued after the effective date of the bill and held for more than five years. The bill would retain the 50% exclusion of gain on the sale of qualified small business stock, as defined, originally issued before the effective date of the bill and held for more than five years.

SUMMARY OF AMENDMENT

The amendments resolve the technical concerns raised in the analysis of February 24, 2000. The term "purchased" is replaced with a common definition that applies the same acquisition requirements to stock before and after the effective date of the bill. The amendments also provide the rules to be used where conversion transactions occur. They also provide the rules relating to investors who own qualified small business stock through a pass-through entity or who acquire that stock by gift, inheritance, or upon a tax-free in-kind distribution from a pass-through entity. In addition, special rules are provided for reorganizations that provide how tax-deferred exchanges of qualified small business stock would be treated when the acquired stock is later disposed of in a taxable transaction.

A new Specific Findings discussion is provided that details the provisions of the amended bill. For convenience the Fiscal Impact discussion is repeated below. A new Franchise Tax Board position is provided to reflect the position taken at its March 27, 2000, meeting.

Board Position:

X	S		NA		NP
	SA		O		NAR
	N		OUA		PENDING

Department Director	Date
Johnnie Lou Rosas	4/13/00

EFFECTIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2000.

SPECIFIC FINDINGS

Under both federal and California law, noncorporate investors may exclude 50% of the gain realized and recognized on the sale or exchange of qualified small business stock that has been held for more than five years. The amount that a taxpayer may exclude as gain with respect to qualified small business stock issued by the same issuer is limited to the greater of $10 million ($5 million for married individuals filing separate returns) or 10 times the taxpayer's original basis in the stock of the issuing corporation.

To qualify as small business stock for federal purposes, the stock must be that of a "C" corporation. The total gross assets (treating all members of the same parent-subsidiary controlled group as one corporation) of the corporation at all times after August 10, 1993, and before the date of issuance, as well as immediately after the date of issuance, must not exceed $50 million.

The corporation must meet certain reporting requirements. During substantially all of the taxpayer's holding period for the stock, the corporation (other than certain excluded corporations) must meet an active business test. The taxpayer claiming the exclusion must have acquired the stock when the stock was originally issued for money or other property (not including stock) or as compensation for services provided to the corporation.

To qualify as California qualified small business stock, the issuer must meet the following additional rules:

1. Must be doing business in California at all times on or after July 1, 1993;

2. Must have assets of $50 million or less, when measured as a controlled group using modified federal rules, before the issuance of the stock; and

3. Must have at least 80% of the total dollar value of its payroll attributable to employment located in California.

For both federal and California purposes, one-half of the amount of gain excluded is treated as a preference item under the alternative minimum tax (AMT).

This bill would increase the percentage of gain excluded from income from 50% of the gain to 100% of the gain for qualified small business stock, as defined, that is acquired after the effective date of these amendments in 2000 and held for more than five years. This bill retains the 50% exclusion of the gain for qualified small business stock, as defined, that is acquired before the effective date of the amendments made by this bill in 2000 and held for more than five years.

The definition of qualified small business stock would be clarified to provide that stock originally issued on or after the effective date of the bill would qualify for the 100% exclusion so long as that stock is acquired at original issuance in exchange for money or other property (not including stock), or as compensation for services and held for more than five years.

The conversion rules (such as the conversion of preferred stock into common stock) for qualified small business stock would be modified to provide that where the original converted stock qualified for either the 50% or 100% exclusion, then the common stock received on the conversion would qualify for the same percentage exclusion as the original stock.

This bill also would provide that in the case of investors who own qualified small business stock through a pass-through entity, or who acquire that stock by gift, inheritance, or upon a tax-free in-kind distribution from a pass-through entity, that the determination of whether the 50% or 100% exclusion applies would be determined by reference to the original acquisition of that stock by the pass-through entity, donor (in the case of a gift), or decedent (in the case of an inheritance).

In addition, **this bill** would enact special rules for reorganizations that provide how tax-deferred exchanges of qualified small business stock would be treated when the acquired stock is later disposed of in a taxable transaction. These rules would provide that if 100% exclusion stock is received in exchange for 50% exclusion stock, the ultimate exclusion percentage allowed when a taxable disposition occurs would be determined under the 50% exclusion rules. Conversely, if 50% exclusion stock is received in exchange for 100% exclusion stock, the ultimate exclusion percentage allowed when a taxable disposition occurs would be determined under the 100% exclusion rules. No change is made to the existing law portion of these rules when non-qualified small business stock is received in a tax-deferred transaction.

One-half of the amount of gain excluded under this provision would continue to be treated as a preference item under the alternative minimum tax (AMT).

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department’s costs.

Tax Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Fiscal Year Cash Flow Purchases After Enactment Date Enactment Assumed On September 1,2000 $ Millions		
2005-06	2006-07	2007-08
-$15	-$38	-$50

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of this measure would depend on the amount invested in qualified stock after the enactment date, the rate of growth of market value of qualified stock, and the amount of gains realized upon disposition after a minimum holding period of five years.

Estimates above are based on the same methodology used previously to project the impact of the current law extension of the 50% exclusion indefinitely. These estimates allow for the minimum five-year holding period requirement and the interaction with the tentative minimum tax. Allowance was also made for some taxpayers delaying purchases of qualified stock to meet the enactment date requirement.

BOARD POSITION

Support.

At its March 27, 2000, meeting, the Franchise Tax Board voted 2-0 to support this bill with Member B. Timothy Gage, abstaining.